

Office of Chief Counsel
Internal Revenue Service

memorandum

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RTBennett

date: June 10, 2002

to: Charles Chiapperino, International Examiner

from: Area Counsel
(Heavy Manufacturing and Transportation:Edison)

subject: **Section 304**
Withholding on dividends
Taxpayer: [REDACTED]
EIN: [REDACTED]
UILs: 304.02-02, 304.02-03, 304.02-04. 304.02-06, 1442.03-00,
9114.03-42

This memorandum responds to your request for assistance dated April 26, 2002. This memorandum should not be cited as precedent.

Facts.

The taxpayer is [REDACTED], Inc. ("[REDACTED]") and subsidiaries. [REDACTED] is a dual resident under the U.S.-U.K. income tax treaty. At all times relevant to this advisory, [REDACTED] was wholly owned by its United Kingdom parent [REDACTED] PLC ("[REDACTED]"). [REDACTED] wholly owned the U.S. corporation [REDACTED], Inc. ("[REDACTED]") which in turn wholly owned the U.K. corporation [REDACTED], Ltd. ("[REDACTED]").

[REDACTED], [REDACTED] and [REDACTED] were formed in [REDACTED] through [REDACTED] with nominal capital contributions. [REDACTED] claims that these entities were formed in order to facilitate a de-merger of [REDACTED]. Since their formations, [REDACTED] and [REDACTED] were part of the same affiliated group filing a consolidated return (the "[REDACTED]").

As part of the demerger, on [REDACTED] [REDACTED] sold its stock in certain wholly owned non-US entities ("foreign entities") to [REDACTED] for approximately \$[REDACTED]. The foreign entities were not engaged in any trade or business in the United States. Also, at the time all of [REDACTED]'s earnings were U.S. sourced. According to the examination team, [REDACTED] and [REDACTED] treated this transaction as a taxable sale. Subsequent to the transaction, the foreign entities and [REDACTED] made investments in

U.S. property under section 956, which were includable in the income of the [REDACTED] under section 951. [REDACTED] took foreign tax credits as a result of the section 951 inclusions (section 902(a) and 960(a)(1)).

The examination team has requested our advice whether [REDACTED]'s transfer of the stock of the foreign entities to [REDACTED] in exchange for cash falls under section 304.

The examination team also may propose that [REDACTED] overpaid [REDACTED] for the foreign entities. Consequently, the team may propose an adjustment which would decrease the amount considered paid by [REDACTED] for the foreign entities with the difference being a constructive dividend paid by [REDACTED] up the chain of corporations to [REDACTED].¹ Examination has also requested our advice regarding the U.S. withholding requirements on the constructive dividend paid up the chain as a result of this valuation adjustment.

Issues.

1. Whether [REDACTED]'s transfer of stock of the foreign entities to [REDACTED] in exchange for cash falls under section 304?
2. Whether a constructive dividend paid by [REDACTED] to [REDACTED] is subject to withholding?
3. Whether a constructive dividend paid by [REDACTED] to [REDACTED] is subject to withholding?

Conclusions.

1. [REDACTED]'s transfer of stock of the foreign entities to [REDACTED] in exchange for cash falls under section 304.
2. A constructive dividend paid by [REDACTED] to [REDACTED] is not subject to withholding.
3. A constructive dividend paid by [REDACTED] to [REDACTED] is subject to a

¹This advisory also concerns the taxpayer [REDACTED], Inc. and subsidiaries ("[REDACTED]"). [REDACTED] was de-merged from [REDACTED] in [REDACTED]. The domestic counterparts of some of the foreign entities sold by [REDACTED] to [REDACTED] became part of the [REDACTED] of affiliated corporations. Given the method by which the examination team proposes to value the foreign entities, the values of their domestic counterparts will be adjusted as well.

■% withholding under the U.S.-U.K. treaty.

Discussion.

A. Section 304.

Section 304(a)(1), as in effect for the transfer at issue, stated,

Acquisition By Related Corporation (Other Than
Subsidiary)- For purposes of sections 302 and 303, if-

(A) one or more persons are in control of
each of two corporations, and

(B) in return for property, one of the
corporations acquires stock in the other corporation
from the person (or persons) so in control,

then (unless paragraph (2) applies) such property
shall be treated as a distribution in redemption of the
stock of the corporation acquiring the stock. To the
extent that such distribution is treated as a
distribution to which section 301 applies, the stock so
acquired shall be treated as having been transferred by
the person from whom acquired, and having been received
by the corporation acquiring it, as a contribution to
the capital of such corporation.²

²Section 304(a)(2) applies to parent subsidiary
acquisitions. Because of the application of the section 318
attribution rules, every section 304(a)(1) transaction where the
seller controls both the issuing and acquiring corporation by
attribution could be considered covered under section 304(a)(2).
Therefore, the plain language "unless paragraph (2) applies"
would seem to indicate that (a)(2) always trumps (a)(1) when both
apply. However, such is not the case. Any section 304(a)(1)
situation remains under section 304(a)(1) unless section
304(a)(2) "is implicated by reason of the issuer's actual
ownership of stock of the acquiror." David H. Brockway, "Section
304 Is Very Strange," 97 TNT 132-35 (July 10, 1997) (citations
omitted).

Section 304(a)(1) was amended in 1997. For distributions

The determination of whether the acquisition is to be treated as a distribution in part or full payment in exchange for the stock (or instead as a distribution under section 301) is made by reference to the stock of the issuing corporation. Section 304(b)(1). In our case, [REDACTED] is a corporation that is in control of both the foreign entities and [REDACTED]. First, [REDACTED] directly owns the foreign entities. Second, under section 304, the attribution rules of section 318(a) apply for determining control, with certain modifications. Section 304(b). Under section 318(a)(2)(C) "[i]f 50 percent or more in value of the stock in a corporation is owned by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation." Section 304(c)(3)(B)(i) substitutes "5 percent" for "50 percent." Since [REDACTED] owns [REDACTED]% of [REDACTED] which owns [REDACTED]% of [REDACTED] which owns [REDACTED]% of [REDACTED], [REDACTED] is deemed to actually own [REDACTED]% of [REDACTED]. Section 318(a)(2)(C) and (a)(5).

As a result of the attribution rules, [REDACTED]'s transfer of the foreign entities to [REDACTED] falls under section 304(a)(1). [REDACTED] controls both the foreign entities and [REDACTED]. Pursuant to section 304(a)(1), to the extent that the transaction is considered to fall under section 301, the transfer is deemed to be a capital contribution by [REDACTED] of the stock of the foreign entities to [REDACTED]. Therefore, it is necessary to determine whether under section 302 the redemption is treated as a distribution under section 301.

Under section 302(a), a redemption of stock will be treated as a distribution unless the redemption falls within sub-paragraphs (1) through (4) of section 302(b). In our case, none of the sub-paragraphs apply. Section 304(b)(1) provides that the applicability of section 302(b) is made by reference to the stock of the issuing corporation. Under the attribution rules, after the transfer [REDACTED] is considered as still owning [REDACTED]% of each of the foreign entities. Sections 302(b)(1) and 318(a)(2)(C). Therefore, under section 302(d) the redemption is

and acquisitions after June 8, 1997, section 304(a)(1) provides "[t]o the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction."

treated as a distribution under section 301. Consequently, the \$ [REDACTED] is treated as a distribution directly to [REDACTED]. The determination of the amount and source of the dividend portion of the distribution is made as if the property was distributed first by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. Section 304(b)(2)(A) and (B). Therefore, the distribution in our case is considered to be first from the earnings and profits of [REDACTED] and then from the earnings and profits of the foreign entities.

It is clear from an analysis of Rev. Rul. 70-496, 1970-2 CB 74 that it is the Service's position that the dividend distribution (to the extent of the earnings and profits of the acquiring corporation) is treated as being made directly from the acquiring corporation ([REDACTED]) to the transferor corporation ([REDACTED]) even though [REDACTED] does not directly own the stock of [REDACTED]. It is also clear that [REDACTED] is treated as contributing the stock of the foreign entities to [REDACTED] even though [REDACTED] does not directly own stock in [REDACTED]. The dividend distribution to [REDACTED] by [REDACTED] and the contribution of the stock (of the foreign entities) to [REDACTED] are not run through the various tier entities. Thus, this is different than the treatment of the constructive dividends discussed later in this memorandum.

Since [REDACTED] is considered as having contributed the stock of the foreign entities to [REDACTED], [REDACTED]'s basis in the stock is the same as it was in the hands of [REDACTED]. Section 362. After the deemed redemption, [REDACTED] does not have a direct interest in either the foreign entities nor [REDACTED] and therefore its basis in the stock of the contributed foreign entities may disappear. Rev. Rul. 70-496.

Temp. Treas. Reg. §1.304-4T states in full that,

"At the discretion of the District Director, for purposes of determining the amount constituting a dividend, and source thereof, under section 304(b)(2), a corporation (deemed acquiring corporation) will be considered to have acquired for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if one of the principal purposes for creating, organizing, or funding the acquiring corporation, through capital contributions or debt, is to avoid the application of section 304 to the deemed acquiring corporation."

In our case, Temp. Reg. §1.304-4T(a) may be applied to treat

██████ as the "deemed acquiring corporation" for purposes of section 304. However, for this temporary regulation to apply it would be necessary to determine that one of the principle purposes of establishing ██████ was to avoid the application of section 304 to ██████. It should be noted that if Temp. Treas. Reg. §1.304-4T(a) is applied, ██████ would be required to withhold tax on the dividend deemed paid by ██████ to ██████ and would be entitled to be withheld at the favorable U.S.-U.K. treaty rate. See Rev. Rul. 92-85, 1992-2 C.B. 69. The earnings and profits of ██████ and the foreign entities would be looked at to determine the portion treated as a dividend from ██████ to ██████ and the portion treated as a dividend from the foreign entities to ██████. If Temp. Treas. Reg. §1.304-4T does not apply, then the earnings and profits of ██████ and the foreign entities would determine the portion treated as a dividend from ██████ (if any) and the portion treated as dividend from the foreign entities to ██████. To the extent any portion of the distribution is treated as a dividend from the foreign entities to ██████, it would not be subject to withholding. However, the earnings and profits of such foreign entities would be reduced by the amount of such deemed dividend.

Assuming ██████ is considered the acquiring corporation, the fact that the issuing corporation, acquiring corporation and controlling or transferring corporation are all foreign entities should not prohibit the application of section 304. We are not aware of any authority addressing this situation. However, we do not see any reason why section 304 should not apply simply because the parties are all foreign.

The application of section 304 directly affects the earnings and profits of both ██████ and the foreign entities. The examination team believes that a reduction in the earnings and profits of the foreign entities will reduce the amount of investments of earnings in U.S. property under section 956 made by the foreign entities. This will eliminate foreign tax credits deemed paid by ██████ and ██████ as a result of the section 960 deemed dividends. The examination team has determined that the net effect of this adjustment would increase U.S. income tax of ██████ since the amount of foreign tax credits eliminated would be greater than the amount of income eliminated.

On April 10, 2002, the examination team and counsel from our office held a meeting with Robert Adams, the Senior Industry Advisor for Heavy Manufacturing and Transportation. Mr. Adams agreed that section 304 applied to the transfer.

B. Withholding on dividends.

As stated in the facts above, the examination team also may propose that [REDACTED] overpaid for the foreign entities and therefore there is a constructive dividend of the difference up the chain of corporations to [REDACTED]. Here, the dividend would be paid by [REDACTED] to [REDACTED] to [REDACTED] to [REDACTED]. Therefore, there are issues regarding withholding on the dividends paid by [REDACTED] to [REDACTED] and [REDACTED] to [REDACTED] respectively.³

Generally, under section 881(a)(1), there is a tax of 30 percent imposed upon a dividend received by a foreign corporation from US sources to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States. Section 1442(a) imposes a withholding requirement of 30 percent on such a dividend in the United States. Treas. Reg. §1.1441-1 provides for withholding of a tax of 30 percent on items specified in Treas. Reg. §1.1441-2 which constitute gross income from sources within the United States when such income is paid to a foreign corporation. Treas. Reg. §1.1441-2 includes dividends. This 30 percent rate may be reduced by treaty. Treas. Reg. §1.1441-1.

Under the United Kingdom- U.S. Income Tax Treaty⁴ ("Treaty") a corporation which is both a resident of the United Kingdom and a resident of the United States is not entitled to claim relief

³The dividend paid by [REDACTED], a United Kingdom company, to [REDACTED] would not be subject to withholding in the United States. However, since [REDACTED] owns [REDACTED] percent or more ([REDACTED]%) of the voting stock in [REDACTED] it will be entitled to the indirect foreign tax credit with respect to this dividend. Sections 902(a) and 960. [REDACTED] must also "gross up" the amount of the dividend income received by the foreign taxes deemed paid. Section 78. To the extent that the earnings and profits of [REDACTED] were included in the income of [REDACTED] as a U.S. shareholder under section 951(a), the earnings and profits should not again be included in the gross income of [REDACTED]. Section 959(a).

⁴The formal name of the treaty is the "Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains" (April 25, 1980), U.S.-U.K. T.I.A.S. No. 9682, 1980-1 C.B. 394 amended by three protocols entered into force on April 25, 1989, April 25, 1980 and April 25, 1980 respectively. A new treaty has recently been signed but not entered into force yet.

or exemption from tax under the Treaty, with certain exceptions. Treaty, Art. 1(2). The Treaty defines a corporate "resident of the United Kingdom" as "a corporation whose business is managed and controlled in the United Kingdom." Treaty, Art. 4(1)(a)(ii). The treaty defines a corporate "resident of the United States" as "a United States corporation." Treaty, Art. 4(1)(b)(ii). Generally, the Treaty defines a "United States corporation" as a corporation incorporated in the United States. Treaty, Art. 3(1)(b)(i).

The Treasury Department's Technical Explanation of the Treaty, CCH Tax Treaties at ¶10,941 provides an example:

"...a dual resident corporation may not claim the exemption from tax with respect to interest derived from the United States under Article 11 (Interest) or claim a refund of advance corporation tax with respect to a dividend received from a corporation which is a resident of the United Kingdom. In these cases the dual resident is treated as a resident of neither Contracting State for purposes of the Convention."

■ is a dual resident corporation under the treaty because it is both a U.S. corporation and managed and controlled in the ■.

Article 10 of the Treaty governs dividends. Article 10(3) defines a "dividend" for United States tax purposes as a distribution out of earnings and profits. This is consistent with section 301(c)(1). Article 10(1) provides that a contracting state could tax dividends paid to one of its residents by a resident of the other contracting state. Under Article 10(2)(b)(i), in the case of a dividend paid by a United States corporation to a corporation which is a resident of the United Kingdom which controls at least 10 percent of the voting stock of the U.S. corporation paying the dividend, the United States may impose a withholding tax of 5 percent.

1. Dividend paid by ■ to ■.

In our case, with regards to the dividend paid from the United States corporation ■ to the dual resident ■, the beneficial ■ percent withholding rate under the Treaty may not apply because the recipient is a dual resident and therefore the treaty is inapplicable. See Treaty, Art. 1(2). The statutory amount of ■ percent withholding provided under section 1442(a) would therefore generally be applicable to this dividend if paid to a foreign corporation. However, the fact that the parent corporation is a U.S. corporation alters this application of

section 1442(a).

The withholding requirements under section 1442 apply only to payments made to foreign corporations. Treas. Regs. §§1.1442-1 and 1.1441-1. While [REDACTED] is both a domestic and foreign corporation for purposes of the U.S.-U.K. income tax treaty, the fact that [REDACTED] is taxed on the dividend the same as a domestic corporation for US tax purposes eliminates the necessity for withholding. Therefore, section 1442 should not apply and there should not be any withholding on the dividend.

2. Dividend from [REDACTED] to [REDACTED].

With regards to the second dividend, the dual resident [REDACTED] pays a dividend to its parent corporation [REDACTED], which is solely a resident of the United Kingdom under the Treaty. At first blush it appears that since the dividend is paid by a dual resident, and a dual resident can not take advantage of treaty benefits, there would be a 30 percent withholding imposed in the United States under sections 881(a)(1) and 1441(a). However, the beneficial rate of 5 percent under the Treaty is available to the United Kingdom corporation in this situation. According to the Treasury Department's Technical Explanation of the Treaty, CCH Tax Treaties ¶10,941,

"...dividends derived by a resident of a Contracting State from a dual-resident corporation will qualify for the exemption or reduction in tax allowed by the Convention. **For example, dividends received by a resident of the United Kingdom from a dual-resident corporation will qualify for the reductions in United States resident withholding under paragraph (1) of Article 10 (Dividends)...**" (emphasis added).

Therefore, in our case, the dividend paid by the dual resident corporation [REDACTED] to its United Kingdom parent [REDACTED] would be subject only to a maximum [REDACTED] percent withholding in the United States under Article 10(2)(b)(i) of the Treaty.

Overall, the dividend paid by [REDACTED] to [REDACTED] is not subject to withholding tax in the United States. The dividend paid by [REDACTED] to [REDACTED] is subject to a maximum [REDACTED] percent withholding in the United States pursuant to Article 10(2)(b)(i) of the Treaty.

C. Interaction between section 304 dividend and valuation dividend.

Assuming that the examination team proposes constructive

dividends because of an overvaluation of the foreign entities, the distribution under section 301 which results from the application of section 304 will be an amount less than \$ [REDACTED]. In determining the amount of the property (cash) received by the transferor ([REDACTED]) in return for stock (foreign entities) from the acquiring corporation ([REDACTED] (or [REDACTED] if Temp. Treas. Reg. §1.304-4T is found to apply)) the examination team should use the value of the foreign entities it determines to be correct. The difference between this correct value and the \$ [REDACTED] will be the amount of the dividends up the chain of corporations. Again, the section 304 deemed dividend is considered as being paid directly by the acquiring corporation to the transferor and/or by the foreign entities to the transferor.

If the examination team does not propose any adjustment to the valuation of the foreign entities, or the taxpayer persuades the Service that the valuation was correct at \$ [REDACTED], then for purposes of section 304 the value of the "property" distributed should be the full amount \$ [REDACTED].

Please be advised that this advisory memorandum is subject to post review by our National Office. If you have any questions, please contact attorney Robert T. Bennett of our office at (973) 645-3244.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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